INTEREST RATE ENVIRONMENT

Recent comments by the Federal Reserve and certain economic conditions seem to indicate interest rates could begin to increase within the next six months. The fact the discount rate is now at a 45 year low also increases the probability of a rate hike. Once interest rates begin to move the question becomes how far will they rise and how fast will it happen. Credit union response to this question is critical to providing the best service to members and sound asset/liability management.

Although there are many considerations in pricing shares and loans credit unions must make adjustments to match market conditions. Credit unions should know under what circumstances that certain rates would almost be automatically adjusted. Many credit unions already are familiar with this concept as money market and variable rate loans are re-priced according to an index.

Adjusting dividend and loan rates on a timely basis is critical to success. Much can be said for making these decisions on pricing at least as often as when the Federal Reserve adjusts rates. Failure to adjust rates on a timely basis becomes more critical depending on how quickly and how far rates increase.

Many credit unions failed to adjust rates on a timely basis during the most recent decrease. The result was they attracted deposits at a higher cost than they could effectively use, loans decreased because members could find less expensive financing and net margins decreased. It is likely the opposite effect will take place as rates rise if credit unions do not adjust rates in response to market conditions. One additional concern in this scenario is liquidity.

Credit unions should establish procedures so they know when and under what circumstances action must be taken on decisions regarding pricing of shares and loans.

LENDING

Return Analysis-

Sound financial management requires a routine analysis of the return on the loan portfolio. At least three areas need to be reviewed:

1) *Risk Based Pricing*

   Be sure to review each risk level to determine profitability. To gauge whether each tier is profitable, management must be able to identify the loans within that tier. Use of a designated field to record the grade of paper will facilitate the financial analysis.

   Tracking of delinquency and net charge offs per grade of paper can then be factored into the profitability of each tier. This enables management to review the scores for each particular tier and determine that the pricing is appropriate.

2) *Credit Card Portfolios*

A recent article in a trade publication noted that 100 credit unions across the country have sold their credit card portfolios. Within Missouri, at least five credit unions have sold their portfolios.

Determining whether or not to hold your credit card portfolio is an individual decision. However, several credit unions have obviously decided that this program is not providing an adequate return. If you haven't reviewed your program within the past twelve months, it is time for an analysis. Consideration must be given to many factors, including net charge offs, staff time, and other indirect costs. If the program is not profitable, you may wish to sell the portfolio or provide the service through alternative means.

3) *Vendor Reviews*

   Some products have profitability studies performed by the vendor providing the product. Regardless of the product, credit union management must be suspect of profitability reviews performed by the party making a profit from the sale of the item. It is difficult for these reviews to be objective.

   One specific case is the review of Centrix loans. To properly determine the profitability of the portfolio, management should not rely on the vendor. Rather, management should pick a pool of loans granted within a relatively short timeframe and follow those loans through a 24-36 month period. Early payoffs, initial fees, and net charge offs should all be included in the determination of the yield on the portfolio.

Sound management requires routine review of each loan product. The review should determine that you are not only meeting your member's needs but are also contributing to the overall success of the operation.

Loan Demand-

One of management's biggest challenges at present is stimulating consumer loan demand. Currently, the loan/share ratio for all Missouri credit unions is 78.5%. This is higher than the 71% of all federally insured credit unions in the U.S.; however, generating ample loan demand is still a burden. Building additional loan demand is key to producing solid earnings and improving net worth as well as serving the membership.

To meet/beat the competition and stimulate loan growth, each credit union needs to review the efficiency and effectiveness of the loan granting process.

1) *Member Information*

   At one point in time, most credit unions verified the member's pay stub and calculated debt/income ratios (DIR) to determine the member's credit worthiness. However, with the use of credit scores to predict the member's potential to repay the loan, credit unions have generally moved away from income verification and DIR's and have moved toward a faster, more efficient method of predicting repayment. If you are still verifying income or calculating debt/income ratios, you may wish to review your approval process. Generally, a quick review of the member's credit report and determination of the credit score enables the loan officer to provide the member an immediate answer to the loan application. Providing the member with a rapid response generally stimulates member applications and hopefully generates additional loan volume.

2) *Risk Based Pricing*

How do you compete with dealer financing? Member education is definitely a key. However, it is undoubtedly a difficult task to convince the member that you can, in fact, beat the competition.

Pricing the loan based on risk may assist in closing the loan. Not only does this method permit the credit union to serve the weaker credit quality but it rewards the member with a strong credit history. Rather than 'risk based pricing', you may want to take the approach of 'performance based pricing.' Members should be aware that a positive credit history is rewarded with favorable pricing.

3) *Know Your Members*

Each field of membership has its own personality. Identifying those items for which your members will go into debt is imperative to funding loan demand. Be creative --- modify maturities, look at different types of collateral, review pricing. Think 'out of the box' to grab your member's attention and promote loan growth.

Stimulating loan growth requires an efficient, effective loan approval process. Quick turn-around, easy access, as well as reasonable pricing are all components of good lending.